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DDI- 04457/84 25X1

1 AUG 1984

MEMORANDUM FOR: Deputy Director of Central Intelligence

THROUGH: Deputy Director for Intelligence

FROM: [REDACTED] 25X1

Acting Director of Soviet Analysis

SUBJECT: The Major Revision of the Agency's Estimate
of Soviet Defense Spending

1. Action: No action required, for your information only. (U)

2. Background: This memorandum responds to your request for background on the major change made in the mid-seventies in the Agency's estimates of Soviet defense spending. It also outlines the steps taken to avoid a reoccurrence of that event. (U)

The Change and Its Implications

3. The Agency has been assessing the resource implications of Soviet defense activities for nearly 30 years. The estimates are based directly on the Community's assessments of Soviet forces. From the outset the entire data base underlying our estimates has been reviewed and revised annually to assure it accurately reflects the latest information on Soviet forces. Normally the annual revisions result in small changes in the resource assessments. In 1976, however, we essentially doubled our ruble estimate for the entire time series. About 90% of the change was based on our revision of the costs of Soviet defense activities--primarily the prices for military hardware--with only about 10% from revisions in our force estimates. This occurred as a result of our misreading the implications for prices of military hardware in the 1967 Soviet industrial price reform. [REDACTED] 25X1

4. Since the reason for the change was a reassessment of ruble prices the revision did not change our perception of:

- the magnitude and capabilities of Soviet military forces;
- the dollar costs of Soviet military activities.

The new estimates did result in substantial changes in our perceptions of:

- the level of Soviet defense outlays expressed in rubles (but not the trend over time);
- the share of GNP devoted to defense (but not the trend over time) [REDACTED]

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How It Happened

5. We believe that our estimates prepared in the 1950s and 1960s correctly portrayed Soviet defense costs as the Ministry of Defense perceived them. These estimates were presented in 1955 prices, the price base used by the Soviets until the 1967 reform. It wasn't until the mid-seventies, however, that we learned that the military equipment prices in the 1955 base were artificially low and the cost of defense hardware was being subsidized by the rest of the economy. Without that knowledge at the time, the Agency began a short-term research effort to move its military-economic analysis to the new price base shortly after the Soviets announced the 1967 reform. In the early seventies we published our first estimates in the new price base which we believed fairly represented the full implementation of the 1967 reform. This was, on the defense side, based on hasty research and resulted in an assessment that military hardware costs in the new price base should only be adjusted marginally relative to the old (1955) price base. In fact, we now believe the effect of the price reform was to raise military hardware prices so that they reflected true costs. [REDACTED]

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6. Subsequent to that cursory review and revision we increased our efforts to expand our collection of military equipment prices in the new ruble price base. It soon became clear that most of the new prices we were collecting were substantially higher than we expected and we thus initiated a new review of our estimates of the prices for military hardware. In 1974-75 we had a revision underway based on this work which would have raised our estimates (for the entire time series) by a third or more. Work on that estimate was halted by "an intelligence breakthrough" [REDACTED]

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[REDACTED] showed us the full magnitude of our error. After about one year's work by an interagency working group, [REDACTED] the full results were published in 1976--and accepted by the Community. [REDACTED]

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7. Having made this major revision, the DDI redoubled its efforts to [REDACTED]

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[REDACTED] his effort paid off by [REDACTED] greatly increasing our data base. Today we have several times the number of prices we had prior to the 1976 revision and we have a clearer picture of the precision and composition of those prices. This collection and analysis effort has reconfirmed the results of that revision. [REDACTED]

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Current Efforts Underway As We Assess the Latest Reform

8. The experience gained in the seventies clearly shows we must be diligent in our analysis and cautious with the results as we move our estimates to the new (January 1982) price base established by the Soviets--only their second major industrial price reform since 1955. Since the 1976 revision of our estimates we have done considerable research and analysis on Soviet price formation and price change as well as the relation between military and civilian prices. We have worked closely with the academic community to draw on its expertise. As part of this effort we sponsored a Price Conference in December 1981 involving several of the country's leading experts on the Soviet economy to discuss the implications of the forthcoming 1982 reform.

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9. While much data has been collected to date, we do not yet have enough information to make even preliminary estimates of defense, GNP, or burden in the new prices. We currently have two projects underway to attack the defense side. One project

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to study possible unannounced interim adjustments in the 1967 base which may have been made through 1980 as a preparatory step to making the adjustment to 1982 prices. The other, through a contract, draws upon the services of two leading US experts

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to determine if alternative sources of data can be exploited to develop price changes in military hardware.

10. In short, we are working with a broad array of collection programs and using more sophisticated techniques than a decade ago. As a result we feel confident that this time we will be able to detect and properly characterize the impact on the military of the 1982 reform.

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